DONALD L. KOHN
FEBRUARY 8, 1988

FOMC BRIEFING

In considering money and credit ranges for 1988, the FOMC faces several questions. The first is what ranges to set for M2, M3 and debt. The second question is whether a range should be established for M1 or another narrow aggregate. The third issue, which is clearly related to the first two, concerns what weight to place on the aggregates in the implementation of policy.

I would like to begin with the last question, since a review of the characteristics of the aggregates, and their place in policy might prove useful background for consideration of the ranges. The current practice of the Committee--to place relatively low weight on strict adherence to money growth ranges--evolved in recent years as these measures seemed to lose their cohesion with the ultimate objectives of policy, such as prices and output. This was especially true of M1; M2 or M3 never seemed to be very closely tied to income except over the longer-run. Certainly various econometric tests suggest fairly large errors in predicting GNP given any of the aggregates. One source of the problem was the process of deregulation and the asset shifts it induced. This process is largely behind us, eliminating one of the sources of uncertainty the FOMC has in the past cited as a reason to downplay the aggregates. And, in fact, while there remains much to be learned about the behavior of money--as illustrated by our experience with demand deposits this year--we have a fairly good understanding of the broad contours of the relationship of various aggregates to income and interest rates. The major problem emerging from our analysis of the experience of the 1980s is that deregulation has left in its wake monetary aggregates that appear to be fairly interest sensitive over periods as long as a year. Such aggregates must be viewed cautiously as ex ante targets of policy, because the growth needed to foster attainment of the ultimate objective for prices and output can vary widely, depending on the strength of underlying demands in the economy and the behavior of interest rates. Thus, the behavior of broad as well as narrow money has to be interpreted together with other information about the economy and prices, as is the Committee's current practice. Even so, having ranges, aside from being required by law, imposes some degree of discipline on the Federal Reserve; growth outside the ranges at least occasions soul searching, if not action to bring it back. And the ranges can communicate to the public information about the Federal Reserve's view of the economic situation and its longer-run intentions with respect to policy.

Turning to the ranges for the broad aggregates and debt, the bluebook suggested three possible alternatives; alternative II represented the tentative ranges for 1988 set in July, alternatives I and III would call for half-point higher and lower growth ranges, respectively. The staff economic forecast, as Mike has already noted, is consistent with growth around the middle of the tentative ranges given in alternative II. That forecast involves interest rates remaining around their recent lower levels for a good part of the year. The effects of the declines in rates since last fall help to boost money growth and depress velocity through the first half of the year. The FOMC is assumed to allow interest rates to drift upward with the pickup in the economy and price pressures that is forecast for later in the year, thereby helping to restrain money growth at that time--at least for M2. For the year, and taking account of the lags involved, interest rates and opportunity costs are expected to have little net effect on money growth, so that M2 and M3 expand relative to income roughly in line with the long-run trends in their velocities.

The pickup in projected M2 and M3 growth from 1987 to 1988 and the weakening in their velocity behavior stems from several sources. One is the pattern of movements in interest rates and opportunity costs; the net movements in opportunity costs over 1988 aren't expected to be very different from those in 1987, but in 1987 much of the increase occurred earlier in the year--through the third quarter--which evidently depressed money growth through year-end, while in 1988 the increase is forecast for late in the year and would have its greatest effects on money demand in 1989. The second is an assumed absence of special factors depressing money growth in 1988. While the factors affecting money growth in 1987 can't be identified with confidence, to the extent they involved the unusually low level of household saving, or the restructuring of household balance sheets away from debt-financed spending owing to the new tax law, they are not expected to be much at work in 1988. Nor is M3 expected to be damped to the same degree by Eurodollar borrowing or inflows of Treasury deposits, both of which were unusually high last year.

With regard to debt, the staff forecast is for some deceleration from 1987 to 1988 on a QIV basis, with this aggregate also growing near the middle of its tentative range. Most of the slowdown is in the federal sectors, reflecting a lower deficit on a calendar year basis and a flat or even declining cash balance. Nonfederal borrowing is expected to slow only modestly, and to remain well in excess of income growth, partly as equity retirements continue to boost debt expansion.

In the context of a staff forecast of money and credit growth in the middle of their tentative ranges, consideration of alternatives to those ranges rests importantly on judgments about the risks to the staff forecast. One set of risks is on the money demand side. If there were a further downward shift in these demands in 1988, it would imply the need for slower money growth to achieve the same economic outcome; a snapback in money demand making up for last year's shortfall would necessitate more rapid money growth consistent with the GNP forecast. The other set of risks involves the performance of the economy and prices. If demands on the economy turned out to be weaker than forecast, a more expansive monetary policy, involving lower interest or exchange rates than in the staff forecast and higher money growth, might be necessary to foster adequate economic growth. Alternatively, if the risks were seen as more on the side of a stronger expansion of demand and greater price pressures, generated perhaps in the context of international adjustment, slower money growth and higher interest and exchange rates might be appropriate. A different monetary policy might also be considered if something like the staff forecast itself was not thought to be a satisfactory outcome for the economy or inflation.

Of course the ranges for money growth allow for various contingencies to some extent. But, given the elasticities of even M2, growth outside the tentative ranges might easily prove needed if conditions deviate significantly from those expected. For example, our models suggest that a gradual increase or decrease in rates relative to the base line path accumulating to one percentage point by year-end could result in about a 1-1/2 percentage point deviation in M2 from its path, bringing it to around the limits of the tentative ranges. Thus, if the risks were thought strongly to be on one side or another, or even if the Committee thought the risks were balanced, but was more concerned about the consequences of one or another outcome, it might wish to adjust the ranges to reflect those concerns.

In light of the uncertainties to the economy and the interest rate sensitivity of money demand, the Committee may want to consider somewhat wider ranges for the broad aggregates, especially M2. Three point ranges for these aggregates have been the norm, but the interest elasticity of M2 does appear to be a little higher now for periods up to a year. And the experience of the last two years has encompassed M2 growth of both 9-1/2 and 4 percent. A range of 4 to 8 percent for example would be centered on the staff's expectation for M2 growth in 1988. The 8 percent upper limit would permit the relatively rapid monetary growth that might be needed to sustain the economy in the face of weak demands; the 4 percent lower end would mean that the Committee was not necessarily looking for an acceleration in M2 growth from 1987 to 1988, if the lower growth were seen as needed to promote progress toward price stability. A wider M2 range would not be without drawbacks, however. It could be seen as indicating a further retreat from effective monetary targeting, and perhaps less in keeping with the intent of the Humphrey-Hawkins Act.

It also raises questions about the M3 range. This aggregate seems to be less interest elastic than M2, reflecting the steadying influence of credit growth at depository institutions. M3 also tends to grow more rapidly than M2 over time, with its velocity trending downward. In the 1970s M3 targets generally were set above M2 ranges by one percentage point, but this has not been the practice in the 1980s. Even so, should the Committee widen or lower the M2 range, it might consider retaining the tentative M3 range, which also is centered on the staff projections.

The third issue involves targeting M1 or another narrow aggregate. M1 velocity registered only a small increase last year, and is expected to increase about 1 percent again in 1988. Such increases are thought to be roughly in line with its new long-term trend. However, this does not appear to herald the return of a period of damped swings and easily predictable behavior of M1 velocity. Rather, it is an artifact of the patterns of interest rates and offering rate changes experienced over the last year and predicted for this year. Our analysis suggests that M1 remains a very interest sensitive aggregate, and substantial movements in interest rates would have profound effects on its growth and velocity. A narrow M1 range could easily trigger an inappropriate monetary policy response to unexpected developments in the real economy. A range as wide as 6 percentage points would appear to be needed to encompass the same possibilities as implied by a three percentage point range for the broad aggregates. The bluebook table provides three such ranges for the three long-run alternatives if the Committee wishes to consider re-establishing an M1 range. M1A is less interest sensitive, and in certain kinds of simulation experiments seemed to provide a little better guide to policy than M2. However, the demand deposit component of this aggregate appears to be in a state of transition owing to changes in the way banks are compensated for services and in business cash management practices. The evolving relationship of this aggregate to interest rates and income is reflected in the large misses in our demand deposit equation in recent years. Based on the discussion at the last FOMC meeting, the draft directive language did not contemplate a narrow aggregate objective. Instead, the language currently in the directive was shortened and modified slightly.

Notes for FOMC Meeting
February 2, 1988

Sam Y. Cross

Since you last met in mid-December, the dollar has gone through two distinct phases. First, a period of persistent downward pressure that led to record lows around year-end. Then, when trading reopened in New York after the New Year, a sharp dollar recovery triggered by heavy intervention dollar purchases and supported by improved economic statistics. Over the period as a whole, the dollar has risen by about 4 1/2 percent against the mark and about 1 1/2 percent against the yen.

At the time of your December meeting, there was an atmosphere of pervasive pessimism about the dollar in the foreign exchange markets. The market was disappointed by the record trade deficit announced December 10, was disappointed by the modest results of the protracted deliberations on reducing the budget deficit, and was concerned that fears about fragile financial markets and a weaker economy might limit the scope for using monetary policy to support the dollar.

In this environment, the Group of Seven communique issued December 22 provided further disappointment. It contained no explicit new economic policy initiatives to stabilize exchange rates and redress trade imbalances, and public comments by an Administration official seemed to downplay its significance. These cumulative disappointments began to weigh heavily upon dollar exchange rates. During the last week of the year, the negative sentiment showed through in heavy dollar sales, especially by U.S. corporations and Japanese banks. There was very little liquidity in the market; the U.S. interbank market was dormant, with many institutions having closed their books for the year and unwilling to adjust positions, and the market became one-sided. Under these conditions, the central banks were about the only dollar buyers, and large concerted intervention operations conducted in the last few days of the year were required to contain the dollar's decline. By the morning of January 4, the dollar had fallen by around 5 percent against the yen and the mark from the close on December 16.

Within a few days however, as market participants returned to active trading at the beginning of the New Year, the mood changed dramatically. The central banks intervened in concert aggressively, visibly and noisily. The market had been looking for a signal, especially from the U.S., and these operations convinced many market participants that the G-7 countries were indeed now committed to halting the dollar's decline. The December G-7 accord was given new weight.

Thus the climate was much more favorable in mid-January, when the next set of trade data were released, and the announcement of a much greater-than-expected narrowing of the deficit pushed the dollar sharply higher. The improvement in trade performance seemed to confirm the view that the dollar may have bottomed out at year-end, at least for the short term. There has been essentially no intervention since the trade figures.

Also during January, events abroad reinforced a sense of policy coordination. Comments by foreign officials strengthened the view that new initiatives to halt the dollar's decline might be undertaken. The Bundesbank's domestic liquidity actions were interpreted as showing a little more flexibility, and the German shift to a broader monetary aggregate target also left the market with the impression that there may be more room to ease monetary policy if they so choose.

Accordingly, in recent weeks the dollar has traded within a relatively narrow range. We have the impression that a lot of players, corporates and others, have been sitting on the sidelines since year-end, and have not yet decided which way to position. Certainly the concerted intervention in early January got the markets' attention, and they believe that the G-7 authorities are much more committed to resisting a significant dollar fall. Indeed there is a much greater appearance of solidarity among the major nations which goes beyond intervention. Also they see evidence that adjustment is taking place, not only from the good trade figures released in January, but also from the latest GNP data which show lower consumption and higher exports. At the same time they have seen the dollar declining for three years and they've all made money by following that trend. Also they know that the dollar's prospects could be changed by one month's disappointing trade figures, and they know that interest differentials favoring the dollar have narrowed. They are looking for convincing evidence that sustained adjustment will take place and that the dollar will be kept stable enough and attractive enough to bring in the $150 billion needed to finance this year's current account deficit.

In this environment of relative dollar stability, much of the position-taking has focused on the relative movements of the yen and European currencies. The yen's strength relative to European currencies may reflect the fact that Japan's economy is more robust than, in particular, Germany's, and a belief that a relatively larger share of the global adjustment will have to be absorbed by Japan. Also the mark often seems to show more weakness than other currencies when the dollar strengthens. In any case, the relative weakness of the mark has enabled other Europeans to buy large amounts of DM in the market to restore balances and repay debts.

Total dollar purchases in this period have been substantial. The Desk purchased a total of $1,364.5 million against marks and $1057.5 million against yen. The Treasury and the FOMC have operated in roughly equal overall amounts, but the currency composition of the two agencies' intervention has been shifted to take account of the currency composition of their balances. Thus, the Federal Reserve sold $1,216.5 million worth of marks and no yen. Foreign central banks have also made substantial dollar purchases, a total of about $9 billion bought (by the rest of the G-10) during the period from December 16 through yesterday.

In other developments during the period, the Desk purchased $0.7 million equivalent of yen from a customer on behalf of the Federal Reserve System to help reconstitute our balances. The Desk also purchased a total of $195.1 million equivalent of yen against SDR on behalf of the U.S. Treasury to augment yen reserves.

There were also repayments on two Treasury swaps by Latin American debtors: the Argentine central bank repaid $100 million, plus interest, and the Central Bank of Ecuador repaid the outstanding balance of $31 million, plus interest. There are no Treasury swaps now outstanding.

With respect to Federal Reserve swaps, we have renewed all our swap lines for one year without change, in accordance with the Committee's instructions.

Mr. Chairman, I request that the Committee approve the Federal Reserve share of our intervention since December 16, amounting to purchases of $1,216.5 dollars against marks.

NOTES FOR FOMC MEETING
FEBRUARY 9-10, 1988
PETER D. STERNLIGHT

In the period since the mid-December meeting, the Domestic Trading Desk sought first to maintain about unchanged conditions of reserve availability from those prevailing in the previous intermeeting interval. For about the past two weeks however, against a background suggesting weaker economic growth in early 1988, the Desk has encouraged slightly easier conditions. The path level of borrowing was shaved from $300 million to $250 million and the anticipated range of Federal funds trading edged off from about 6-3/4 - 7/8 percent to 6-1/2 - 3/4. The slight shift was made even though money growth was turning in a more robust performance in January after showing considerable weakness in December.

Gradually over the period, and particularly since the Committee's telephone meeting on January 4, we began placing a bit more emphasis on the borrowing objective while getting away from the closer adherence to a Federal funds rate range that characterized the period after the October stock market crash. We still remained quite sensitive to money market conditions, though, and indeed the implementation of a slightly more accommodative posture in the last couple of weeks called for some renewed emphasis on that aspect--as normally occurs when a change of conditions is being undertaken. I do judge from comments heard or seen over the period, however, that a number of market participants were beginning to conclude that the Desk was returning to a more normal mode of operation. That market view is likely to be reinforced when they see the soon-to-be released policy record with its reference to the January 4 directive.

Money market rates have held close to the anticipated ranges, with even the feared year-end period turning out to be only modestly elevated. Two-week averages for Federal funds remained roughly in the 6-3/4 - 7/8 percent range until the current maintenance period, when, as intended, an average closer to 6-1/2 - 5/8 percent is emerging in the second week. A few days around year-end saw rates at or above 7 percent, but this was a far cry from the much sharper pressures of a year earlier. A major reason for the milder experience this time was the absence of the extraordinary tax-driven credit growth and funding needs marking the earlier year-end. To some extent, advance preparations by market participants and by the Desk also helped. We also got some slightly elevated funds rates in mid-January--in the 6-7/8 - 7 percent range-- a circumstance that incidentally helped foster the notion that our Desk was becoming a bit more relaxed about funds rate variation. The first week of the current reserve period saw a 6-3/4 percent rate even though we were by then anticipating a slightly softening picture. In this second week, though, a large accumulation of excess reserves is making itself felt and funds have been largely in a 6-1/2 - 6-5/8 area. Rates were even lower yesterday afternoon and this morning.

Borrowing was a close-to-path $355 million in the December 30 reserve period, perhaps sending a false signal of a return to more expected relationships with funds rates. The next period, which included year-end, saw average borrowing of nearly $1.5 billion. The heaviest borrowing (over $3 billion) was on December 31 and carried over the holiday weekend. As noted, the money market did not appear to be particularly tight that day, but there were heavy flows of funds and apparently some gaps in communications that led to unexpected late outflows and shortages, centered on one large New York bank. Just after that weekend, a fire disrupted computer operations at another large New York bank and in the aftermath some other major banks were forced to the window. The Desk treated the bulk of these unusual borrowings, in effect, as nonborrowed reserves since to do otherwise would have meant flooding the market with reserves and providing quite misleading signals about policy.

In the next period, the latter half of January, borrowing came in below path at about $175 million. We were consciously a bit more generous in reserve provisions in the latter part of that period to avoid the likely tightening that would have emerged in producing borrowing close to path after very light borrowing in the first week. Borrowing has also run below its now reduced path level in the current period, averaging about $150 million thus far.

The quest for a firm and reliable relationship between borrowing and funds rates remains somewhat frustrating. It did appear toward year-end and early in the new year that there was some return toward more "normal" willingness to use the window, even apart from the special heavy borrowings noted earlier. More recently, borrowing has run quite light again--maybe in the wake of the temporarily heavier use around year-end, or because seasonal borrowing is at a low ebb, and perhaps because our own approach to reserve needs, tending at times to adjust for already low borrowing as a reserve period winds up. In any event the post year-end experience seems too brief to draw much in the way of firm conclusions. Worth keeping in mind, though, is that our nostalgia for what we may like to think of as more reliable relationships could be a little misplaced--in that over the long-term there have been only rough and "on the average" relationships with a lot of short-run variability.

Reserve needs in the final weeks of December and the first few days of the new year were met with multiple rounds of repurchase agreements, as we sought to avoid building outright holdings further ahead of large anticipated draining needs. After early January, that absorption need became predominant although there was a temporary injection provided again in late January. On the outright side, the absorption phase entailed run-offs of $2.2 billion of bills (including some to take effect tomorrow), redemption of about $150 million of agency issues and sales to foreign accounts of about $1.4 billion of bills and notes. In the last several days, as Treasury balances dropped, we also undertook sizable matched-sale purchase operations to drain reserves temporarily. The draining operations, both outright and temporary, have been undertaken in a careful, even gingerly, manner, designed to let the intended slightly greater degree of accommodation show through. Partly because of this consideration, and partly because reserve factors did not release as many reserves as had been anticipated earlier, the outright reduction in System holdings--about $3.8 billion on a commitment basis--did not nearly exhaust the usual leeway, let alone use the enlarged leeway we had requested for this period.

Fixed income yields fell sharply on balance, reflecting a strong rally late in the period. Yields were fairly mixed and trendless over the first several weeks, as the markets groped for direction in the wake of the stock market crash and the sense of frailty of international economic cooperation. Treasury coupon rates drifted off a bit prior to year-end despite the faltering dollar as many participants felt that monetary policy would come to the aid of the dollar only *in extremis*. Meantime, the domestic market was somewhat encouraged by the recovery of the dollar following heavy central bank intervention just after year-end, although there was skepticism about the durability of the dollar improvement. Yields backed up somewhat in early January following the strong December employment report and rising commodity prices. Mainly, though, there was a marking of time as participants awaited the mid-January report on the November trade deficit. Following publication of a larger-than-expected drop from the outsize October deficit, a major rally developed as the conviction spread that the dollar might be able to stand on its own feet again. Further bond market support followed from reports of weak housing starts, a bulge in inventory growth and flat final sales in the fourth quarter, higher weekly unemployment claims, and then a weaker-than-expected rise in January payroll employment. By the end of the period, yields on Treasury coupon issues were down by about a full percentage point, bringing the long bond yield down to about 8.35 percent. In part, the demand for securities in January reflected sustained foreign central bank purchases.

Markets have been unsure in recent days as to whether the Federal Reserve has adopted an easier policy--with a few more observers gradually concluding that it has--but even among the doubters, many have felt that a somewhat easier posture is just around the corner. Indeed, by some measures of rate relationships, the drop in market yields has already discounted more of a move than has been intended, especially in respect to the short-to-intermediate area. This has led some observers to feel that the market move has been overdone.

In the midst of the rally, the Treasury conducted its big quarterly auctions--$27 billion of 3-, 10- and close to 30-year issues. In the wake of rate declines, final investors were not too enthusiastic in their takings, although Japanese dealer interest was sizable again, and right after the auctions the new issues were at discounts. However, the relatively weak payroll employment rise reported last Friday moved the quotes back above the issue price, and they remained somewhat above water after some profit-taking on Monday. We have mixed reports on how well the issues are distributed, particularly the two longer ones.

In the Treasury bill area, rate declines on key issues were less pronounced over the period, ranging from about 15 - 20 basis points in the 3-month area to around 60 basis points for longer bills. The smaller decline for short issues probably reflects the tendency for shorter rates to be tied more closely to Fed funds and repo rates which came down only modestly, as well as the fact that yields in mid-December were already reflecting some year-end demands. The latest 3- and 6-month issues were sold at about 5.63 and 5.85 percent last Monday, down from 6 and 6.45 percent at mid-December. Meantime, yields in private sector short-term instruments such as on CDs, acceptances, and commercial paper, fell much further than bills--more like 150 basis points--as year-end pressures abated. With costs down materially, banks cut their prime rates 1/4 percent to 8 1/2 percent in early February, and a further reduction would not be all that surprising.

Monetary Policy Briefing
February 10, 1988

Donald L. Kohn

A prominent, and not entirely explicable feature of financial developments since the last FOMC meeting has been the behavior of money--both its continued weakness in December and the sharp turnaround in January.

Taking the two months together, money growth did pick up from the previous several months, at least for M1 and M2. This acceleration probably represents the initial reaction to the decline in interest rates that began after October 19. Looking ahead, the rate declines of last fall along with subsequent decreases since the last FOMC meeting are expected to be boosting money demand over coming months, more than offsetting the effects of relatively slow increases in income. Under alternative B, which assumes rates will remain around the lower levels reached recently, monetary expansion over February and March is predicted to slow from the unusually rapid pace of January, but to remain above the pace of last fall. By March, both M2 and M3 are expected to be 6 to 6-1/2 percent at an annual rate above their fourth quarter levels. If there is a risk to the money forecast, it may even be that it is understated; the drop in interest rates and opportunity costs since last October has been substantial, and the effects might be to boost demands for money and depress velocity by even more than allowed for in the bluebook. Data available since the bluebook was put together, however, suggest little change in the picture presented there.

January seems to be coming in a bit above the growth rates presented there, while data for early February indicate that this month may be getting off to a slightly weaker start than expected.

With respect to the policy choices facing the Committee, as a number of members have already remarked, the decisions made today will probably have their principal impact on the economy in the second half of the year. Thus the question might be whether the financial conditions are now in place to get something like the predicted strengthening of the economy over that period. In the staff forecast, they would be. The recent declines in rates have brought them to about the levels assumed in that forecast for the first half of the year. In markets, this decline reflected in part an expectation that a modest easing of reserve conditions relative to earlier this year had already occurred or was about to happen. Despite the very pronounced movement in long-term rates, however, the yield curve retains a noticable upward slope, which suggests that markets do not see a prolonged period of economic weakness and declining rates. The evidence on real interest rates is somewhat mixed. Falling nominal rates coincided with some pick up in surveyed inflation expectations, but the behavior of commodity prices and the dollar would seen to argue against interpretation of decreasing real rates.

A further substantial easing of policy as under alternative A might be viewed as providing somewhat more assurance on the second half performance. The risk would be that there is sufficient strength already in the economy to produce very rapid second half growth, and the additional ease at this time would require a sharper turnaround at a later date if inflation pressures were to be kept under restraint.

With regard to questions of policy implementation, the draft directive has a modified version of the existing statement on the approach to open market operations. That statement would signify approval of the current approach, which has given substantially less weight to daily federal funds rates than the last months of 1987, but which also has involved fairly frequent informal adjustments to the borrowing objective, given the uncertain state of the borrowing function. The sentence recognizes this situation by acknowledging that conditions have not yet returned to normal, and that flexibility in policy implementation may continue to be needed.